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IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-890

GULF & WESTERN INDUSTRIES, INC.,
Petitioner,

v.

ALLIS-CHALMERS MANUFACTURING COMPANY,
Respondent.

CROSS-PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

WHITNEY NORTH SEYMOUR
One Battery Park Plaza
New York, New York 10004
Counsel for Gulf & Western Industries, Inc.

Of Counsel:

JOHN A. GUZZETTA
BERNHARDT K. WRUBLE
CONRAD K. HARPER
LINDSAY A. LOVEJOY, JR.
Simpson Thacher & Bartlett.

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IN THE

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No. 75-

GULF & WESTERN INDUSTRIES, INC.,
Petitioner,

v.

ALLIS-CHALMERS MANUFACTURING COMPANY,
Respondent.

CROSS-PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Gulf & Western Industries, Inc. ("G&W") cross-petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit entered on September 29, 1975.

A petition for certiorari was filed by Allis-Chalmers Manufacturing Company ("Allis"), the respondent herein, on October 16, 1975 (No. 75-580), with respect to a different aspect of the opinion below, and G&W has filed its "Brief for Respondent in Opposition," dated November 15, 1975, in answer to that petition. Abbreviations, citations and defined terms used herein follow those in G&W's brief in No. 75-580.

Opinions Below, Jurisdiction and Statute Involved

The statute involved is §16(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78p(b). The text of the statute and the other captioned matters are adequately set forth in the petition and brief in opposition in No. 75-580.

Question Presented

Whether the court below erred in departing from the long-established rule that in order to determine whether "any profit" was realized under §16(b), the elements of consideration must be assessed at their fair market value on the date of the transaction, and in creating instead a new rule under which an unsecured six-month $93,680,000 corporate note was valued at its face amount as a matter of law because ultimately paid, thus disregarding the trial court's finding of fact that the note was worth much less on the transaction date, which finding was supported by extensive evidence and was not held to be "clearly erroneous."

Statement of the Case

A comprehensive statement of the case is set forth in the aforesaid brief filed by G&W in No. 75-580. To avoid burdensome repetition, the instant statement assumes familiarity with the prior statement and is confined to facts bearing upon the question presented, which involves the artificial valuation by the court below of a $93,680,000 unsecured 6 month 8½% promissory note issued by White Consolidated Industries, Inc. ("White") as part of the consideration paid to G&W for its Allis shares (the "White note").

On October 31, 1968 G&W and White announced that White would acquire all of G&W's shares of Allis common stock, paying in consideration therefor 250,000 shares of White's common stock and $113,680,000 in cash (Dx-GGGG, ex. 4). However, in the period intervening before the December 6 closing, White was unable to raise even one-fifth of the required cash payment. Reflecting this circumstance, the final form of the parties' agreement* did not require the cash payment. Instead it allowed White an alternative of paying only $20 million in cash and presenting the aforesaid $93,680,000 promissory note (1163a-64), thus requiring G&W to finance White's purchase. White represented that it had received "telephonic commitments" from banks for approximately $50 million of the missing $93 million (1176a), but it was shown that these were infirm commitments, implicity conditioned upon White's obtaining the balance (920a). The agreement required White to pay promptly to G&W all funds obtained to discharge its indebtedness, but at the December 6 closing White had gathered only $20 million and thus delivered its note instead (1175a-76a, 1506a).

The White note constituted a substantial risk, and G&W tried to sell it shortly after the December 6 closing and then again in March 1969. The head of the corporate debt department of one of the nation's leading investment banking houses testified that, on both occasions he was asked to consider purchase of the note, he made a thorough credit study of White and found it to be "in a very unstable, unhealthy financial condition" (496a). He decided that the note was "not financible," and could only be sold through "non-money market agents such as factors" at a discount of 10 to 15 percent from face value. He so advised G&W, and he declined to buy the White note on his firm's behalf or accept it for resale to others (485a-86a, 489a, 497a).

In proceedings instituted by Allis to challenge White's acquisition of Allis shares—while the note was still out-

*The agreement between G&W and White was dated "as of" October 31, 1968, but was not in fact drafted until later, and in original form reflects last-minute changes in different typefaces (Px-12). As reprinted in the joint appendix, the difference in type faces has been eliminated (1163a *et seq.*).

standing—White's chief financial officer gave evidence that if White's investment in Allis common stock was in any way restricted, White would suffer "serious adverse" financial consequences and would be "incapable of amortizing" the debt incurred in acquiring its shares and still continue in business in the ordinary course (1520a). Allis thought this public concession to be so important that it issued its own press release to underscore it (1538a).

Extensive expert financial testimony and other evidence was adduced by both sides concerning the fair value of the White note on December 6, 1968, the date on which G&W received it. Despite different conclusions as to its value, there was general agreement among the experts on two premises: First, that the value of the White note when received by G&W could be determined only by consideration of a number of factors bearing upon whether, when, and to what extent White would be able to discharge the note, including current money-market conditions, White's financial position and the specific characteristics of the note. Second, Allis' own expert testified that the fact the note was ultimately paid in March 1969 "would not be competent evidence" of its value when received by G&W (831a-33a; 1526a). Other witnesses agreed that reliance on subsequent payment was fallacious and an improper use of hindsight, because it is the "very factor of *risk inherent in foresight which determines the valuation issue*" (1526a, emphasis original; 1379a).

The evidence offered on the value of the note was detailed and extensive, and included *inter alia:* G&W's inability to sell it at face value (485a-86a, 489a, 497a); White's own admission as to its potential inability to pay the note (1520a); lack of any security or basic protective covenants (1367a, 1523a); its unusually large amount (502a, 838a, 1517a-18a); its illiquidity (936a, 1368a); the very tight and near chaotic state of the money market (891a, 1514a-16a); the financial condition of White, including its "heavy debt" (496a, 856a, *66a*), its severely wanting "fixed

charges coverage ratio" (914a-17a); the top-heavy ratio of White's long-term debt to net worth (1369a); the uncertainty underlying White's proposed acquisition of Allis (1519a-21a, 1386a); and concluding assessments that the note had a value of from 80% to 93% of its face amount when issued to G&W by White on December 6, 1968 (1371a, 1528a, 496a-497a).*

The sequence of events ultimately leading to the payment of the note illustrated the expert witnesses' conclusion that White's chances of obtaining funds to discharge the note depended largely upon whether its proposed takeover of Allis seemed likely to succeed (1518a-1522a, Px-104 at 15). Such takeover of Allis was White's express purpose in acquiring the Allis shares (1507a), and on December 6, 1968 this prospect was in doubt.** Twelve days after the sale of the shares to White, Allis sought an injunction in the federal district court in Delaware to block White's acquisition on antitrust grounds (1519a). It was in that

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* To support its position that the note should be assessed at face value, Allis largely relied upon its claim that certain of G&W's financial statements had listed the note at its face amount while it was outstanding. However, neither of the courts below gave weight to this contention since there was uncontradicted expert testimony that accounting principles required such treatment because the question of default would be resolved within one year (446a-56a). Moreover, all courts have held that accounting treatment does not bind § 16(b) determinations, since accounting conventions do not correspond to the market value tests of § 16(b). *See, e.g., Stella* v. *Graham-Paige Motors Corp.* (3 decisions), 132 F.Supp. 100, 110-11 (S.D.N.Y. 1955), *aff'd*, 232 F.2d 299, 302 (2 Cir.), *cert. denied*, 352 U.S. 831 (1956); 259 F.2d 476, 481-82 (2 Cir. 1958), *cert. denied*, 359 U.S. 914 (1959).

** As of December 6, 1968 the success of White's proposed takeover was subject to considerable uncertainty. Allis had successfully fended off other unwanted suitors (Dx-GGGG, ex.4), and had just secured a new president (1519a). An FTC investigation to examine the proposed acquisition by White under the antitrust laws had already begun (Dx-GGGG, ex.5). Allis' management publicly announced that it planned no merger with White (*id.*).

action that White's chief financial officer admitted White's potential default on the note (1520a). The district court denied Allis' application on January 22, 1969, *Allis-Chalmers Manufacturing Co.* v. *White Consolidated Industries, Inc.*, 294 F.Supp. 1263 (D. Del. 1969), and on February 3 the Court of Appeals for the Third Circuit denied Allis' application for a temporary restraining order pending appeal, 414 F.2d 506, 509, n. 5 (3 Cir. 1969).

Given an apparent green light for the acquisition, White on March 5 was able to obtain a two year credit agreement with a number of banks and thereby obtain funds to discharge the note, which was still held by G&W following its failure to sell it (1219a). On March 20, White caused the note and accumulated interest to be paid (1295a).

However, after the risk had thus been transferred to the banks, Allis succeeded in turning White's situation around. On May 5, the Court of Appeals for the Third Circuit enjoined the holding of the annual meeting where White hoped to gain control of Allis (1536a; 414 F.2d at 509 n.6). On July 18, 1969 it reversed the district court, enjoined White from voting any or acquiring additional Allis shares or taking action to secure board representation, and thereby halted White's takeover attempt (414 F.2d at 526). As a result, White's banking creditors became "very concerned" and sought relief from the risk by seeking longer-term financing from other sources because of White's financial plight (499a-500a).*

*No such refinancing could be arranged until more than two years later, after White wholly abandoned its takeover bid and reduced its financial commitments (500a; 1253a).

The Decision of the District Court

The district court held that the value of the White note had to be determined, like that of all other consideraton, as of December 6, 1968, the date on which G&W sold its shares and acquired the note; that the test was the "realistic market value" of the White note on the valuation date; that valuations under § 16(b) cannot be based on hindsight, which is essentially erroneous and incompetent *(64a);* and that the note's characteristics, its size, the promissor, the interest rate, and its terms defined it as a hybrid instrument which, "considering a comprehensive evaluation of the opinion of the experts," could have been salable only at a discount (*65a*). The court gave consideration to assessments of White's financial condition, its heavy debt, the unusual nature of the note, the interest rate and the tight money market, and decided that a discount of 5% from face value represented its fair value on December 6, 1968 (*66a*).

The Decision of the Court of Appeals

The court of appeals acknowledged that the valuation of the White note at ninety-five percent of its face amount was "intended to account for the risk factors involved in a note of this size and produce a value" reflecting fair market value (*32a-33a*). It did not question the accuracy of, or foundation for, the district court's finding. Rather, it held that the "difference between the market value of the note" on December 6 and the amount paid on satisfaction of the note three and one-half months later should be added to the recovery as part of the "profit realized". Giving as its reason the general "remedial purpose" of §16(b), the court held it to be a rule of law that (whatever the actual value of the note when it was subject to the risk of nonpayment and whatever the magnitude of that risk) "debt obligations" are to be retroactively valued at face amount if paid in full sometime before trial (*33a*).

The impact of the court of appeals' holding would have exceeded $4 million, had the court not held that the 3,000,000 shares initially acquired by G&W in an Exchange Offer were outside the coverage of §16(b). The latter holding is the subject of Allis' petition in No. 75-580.

Reasons for Granting a Cross-Writ of Certiorari

A cross-writ of certiorari should be granted for several independently sufficient reasons, in that the holding below: (1) is clearly wrong as to an elemental and recurring question in the application of an important federal statute and departs from the overwhelming consensus governing computation of profits under §16(b), thus creating a conflict among the courts of appeals; (2) constitutes a plain circumvention of the mandate of Rule 52(a) F.R.C.P. that the trial court's findings of fact "shall not be set aside unless clearly erroneous"; and (3) is in irreconcilable conflict with *Blau* v. *Lehman,* 368 U.S. 403 (1962), in rationale and result.

In precise statutory terms, §16(b)'s impact is simply to make "any profit" in a set of matched transactions recoverable. 15 U.S.C. §78p(b). As indicated in the Congressional hearings, the statutory purpose was not to deny the investor proper credit for economic costs he had borne or the consideration he had paid, but expressly allowed the investor to "get out what he put in". *Hearings on S. Res. 84 and S. Res. 97 Before the Senate Committee on Banking and Currency,* 73d Cong., 2d Sess., at 6557 (1934). The computation of profit is, under §16(b), a "substantive question fundamental to plaintiff's recovery. It is not merely a question of damages which can be resolved upon an accounting." *Blau* v. *Lamb,* 163 F.Supp. 528 (S.D.N.Y. 1958). See also *Lewis* v. *Nadaline,* [1973-74 Transfer Binder] CCH Fed. Sec. L. Rep. ¶94,507 (S.D.N.Y. 1974); *Kramer* v. *Ayer,* 317 F.Supp. 254 (S.D.N.Y. 1970).

To fulfill the statutory criteria, the plaintiff must establish the value of the consideration given up and received, on and as of the dates when the alleged purchase and sale occurred. Every court which has previously considered the question has held that the statute requires the court to determine the fair value of the elements of consideration "on the day" of the transaction, and that such value is to be established by market evidence and expert testimony, *Stella* v. *Graham-Paige Motors Corp.,* 259 F.2d 476, 481 (2 Cir. 1958), *cert. denied,* 359 U.S. 914 (1959); ***accord, Newmark*** v. *RKO General Corp.,* 425 F.2d 348, 357 (2 Cir.), *cert. denied,* 400 U.S. 854 (1970); ***Blau*** v. ***Mission Corp.,*** 212 F.2d 77, 81 (2 Cir.), *cert. denied,* 347 U.S. 1016 (1954); *Park & Tilford, Inc.* v. *Schulte,* 160 F.2d 984, 988 (2 Cir.), *cert. denied,* 332 U.S. 761 (1947); ***Lewis*** v. ***Dekcraft Corp.,*** [1974-75 Transfer Binder] CCH Fed. Sec. L. Rep. ¶94,905 (S.D.N.Y. 1974); *Lewis* v. *Nadaline, supra; Gold* v. *Scurlock,* 324 F.Supp. 1211, 1216 (E.D. Va. 1971), *aff'd in pertinent part sub nom. Gold* v. *Sloan,* 486 F.2d 340 (4 Cir. 1973), *cert. denied,* 419 U.S. 873 (1974); *Kramer* v. *Ayer, supra; Champion Home Builders Co.* v. *Jeffress,* 385 F.Supp. 245 (E.D. Mich. 1974).

The holding below represents a deviation from this long-established rule. With scarcely a statement of reasons, the court swept away established statutory interpretation, hundreds of pages of expert economic evidence, the unequivocal testimony of a contemporary market-maker that the note had not been worth par, and the considered fact-finding of the district court (*33a*). In economic result, the court arbitrarily denied G&W credit for the risks it bore as the holder of the note during a critical and highly uncertain period when White was unable to obtain financing. These risks represented a genuine and universally recognized economic cost which was ascertainable in amount through the testimony of the several expert witnesses below and confirmed by events occurring while the note was out-

standing. In short, the court created the fiction that G&W had been paid entirely in cash on the date of the sale, while precisely the opposite occurred. Instead G&W accepted a note worth much less than face value, and bore its risk during the period when the question whether, when and to what extent the note's holder would be paid was unanswered.

This is a contrived result which cannot be defended on economic or statutory grounds, and it is at odds with uniform precedent. It even conflicts with the testimony of Allis' own economic expert that the later payment of the note "would not be competent evidence" of its value on the date of the transaction (831a-33a). The court expressly adopted the economically erroneous principle that subsequent events can establish value by "hindsight", even though the risk and uncertainty of payment is what establishes value. As one expert below stated, fair value cannot be shown by "hindsight" because it is the very factor of risk *inherent in foresight which determines the valuation issue*" (1526a) (emphasis in original).

The holding not only contravened the testimony and uniform precedent, but in its operation directly conflicts with the holding of the Second Circuit in *Stella* v. *Graham-Paige Motors Corp., supra,* 259 F.2d at 479, that under § 16(b) it is impermissible for a party to "substitute his hindsight judgment" for contemporaneous conditions which determine market value on the relevant date. Under the ruling below, whatever the prior risks and whatever the real value of a "debt instrument"—bond, note or debenture—payment prior to the time of trial will arbitrarily be substituted for the value the defendant actually received on the date of the transaction.

The vice which underlies the ruling is that it masks the unexpressed substitution by the court of appeals of its own

second-hand response to the trial evidence without coming to grips with the requirements of Rule 52 of the Federal Rules of Civil Procedure, which constrains all appellate review of factual determinations to honor the clearly erroneous rule. *United States* v. *General Dynamics Corp.,* 415 U.S. 486, 508 (1975); *Blau* v. *Lehman, supra,* 368 U.S. at 407. Yet the detailed and extensive economic evidence adduced at trial fully supported the district court's conclusion.*

*There was undisputed, concrete evidence of the risks of the note while it remained unpaid. G&W tried unsuccessfully to negotiate the note at face value with a third party market-maker shortly after December 6 and again in March 1969 (497a). In addition, while the note was still outstanding, White's chief financial officer gave evidence in the injunction suit brought by Allis that if White's efforts to acquire control of Allis were inhibited in any way, it would be impossible for White to pay the note and continue in business (1520a).

The evidence showed, *inter alia,* that the size and risks of the note both in absolute terms and relative to White's financial position were "enormous" and "unusual" (502a, 838a, 1517a-18a); that it was wholly unsecured, bereft of even the most basic protective covenants, without even a "negative mortgage clause" (1367a, 1523a); that it was a "severe strain" on White (1519a); that it was not marketable (1368a); that its illiquidity commaded a discount (936a, 1368a-69a); that the prevailing money-market climate was "one of the toughest markets that we had seen" (891a, 1514a-16a); that while the note was outstanding White was adjudged to be "in a very unstable, unhealthy financial condition" (496a) and upon issuance of the note White's obligations exceeded its net worth by a ratio of 147% (1369a); that White's fixed-charges-coverage ratio, upon which Allis' expert had relied, was erroneously calculated, very much lower and "very severely wanting" (914a-17a); that in two months of effort, White could only raise $20 million, had an absolute deficiency of $43 million, and an infirm possibility of access to $50 million only if all the money could be obtained (920a, 1523a); that the Allis stock did not collateralize the note and in any event was poor collateral which resolved into an equity risk, thus mandating a discount (1386a-87a, 1524a-25a); that *no one* (but G&W) would have been willing to buy the note unless others came in to share the risk—to provide the safety of diversification which G&W did not enjoy (1385a, 1517a-18a); and that White's access to financing depended upon the prospect that it could acquire Allis, which was gravely in doubt (1519a-21a, 1386a). Indeed White succeeded in borrowing funds to pay the note only after Allis had initially been stopped in its efforts to block White's acquisition (1221a).

The error of the court below thus lies not in the misapplication of a rule of law to the facts of a particular case, but rather in the creation of an unacceptable "rule" to compensate for its manifest failure to review those facts as required before disturbing the findings of the trial court. The only support claimed by the court below for its departure from the uniform rule was the "broad remedial purpose" of the statute and its aim of "reducing difficulties in proof" (*33a*), but this rationale cannot stand. In the first place, the proof involved here was of a commonplace variety. More significantly, the Seventh Circuit's underlying rationale, which superimposes a further prophylactic rule on an already prophylactic statute to overturn a finding of fact, was expressly rejected by this Court in *Blau* v. *Lehman, supra.*

There, because of alleged difficulties in proof, potential evasions, and supposed "policy arguments", 368 U.S. at 403, the Court was urged to extend §16(b) liability to include all partnership profits, by treating a partnership as a statutory "insider" if a partner was one. The Court rejected that expansive approach, stating that liability is not to be determined by "adding to the prophylactic effect Congress itself clearly prescribed in §16(b)." *Id.* at 414. It emphasized that the district court's factual findings could not be disturbed because "not clearly erroneous." *Id.* at 407.

In *Blau* v. *Lehman, supra,* the Court held that it would be "nothing but a fiction" to treat the defendant as having realized all the partnership's profits. 368 U.S. at 414. Here, the court below created a fiction in holding that G&W must be treated as having received cash on the date of sale. The proof was exactly the contrary, the clear interim risks of holding the note were arbitrarily erased, and the result reached by the court below was plainly unjust and erroneous.

CONCLUSION

For the reasons set forth above, G&W prays that a cross-writ of certiorari issue to review that aspect of the judgment below set forth in the question presented herein.

Dated: December 23, 1975

Respectfully submitted,

WHITNEY NORTH SEYMOUR
One Battery Park Plaza
New York, New York 10004
Counsel for Gulf & Western Industries, Inc.

Of Counsel:

JOHN A. GUZZETTA
BERNHARDT K. WRUBLE
CONRAD K. HARPER
LINDSAY A. LOVEJOY, JR.
Simpson Thacher & Bartlett.